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At-Risk Revisited: A Re-Examination of the Impact of the Tax Reform Act of 1976 on the Motion Picture Industry

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"AT-RISK" REVISITED: A RE-EXAMINATION OF THE IMPACT OF THE TAX REFORM ACT OF 1976 ON THE MOTION PICTURE INDUSTRY

INTRODUCTION

The Tax Reform Act of 1976[1] dramatically changed the approach to investments in five types of high-risk ventures.[2] Prior to the Act, investments in oil and gas drilling, farm operations, equipment leasing, and motion pictures had benefited from favorable tax incentives. Congress responded to the alleged abuse of these tax shelters[3] by enacting the "at-risk" provisions of section 465 of the Internal Revenue Code.[4] The at-risk rules limit the deduction of losses incurred in these activities to the amount the taxpayer has at-risk[5] and apply to all taxpayers, except corporations which are not personal holding companies or Subchapter S corporations.[6]

One of the areas of abuse specifically named in the Act was the activity of "holding, producing, or distributing motion picture films . . . ."[7] Before 1976 such tax-oriented investments typically used a limited partnership in the investment vehicle.[8] These partnerships[9]

1. PUB. L. NO. 94-455, 90 STAT. 1520 (1976), (hereinafter cited as the "Act").

2. I.R.C. § 465(c)(3)(A) (West Supp. 1982). The scope of the at-risk rules was expanded in 1978 to include all activities "Engaged in by the taxpayer in carrying on a trade or business or for the production of income."

3. Sheltering of income involves the "creation of investments" which produce immediate deductions "of the appropriate character and of sufficient magnitude to reduce or eliminate otherwise taxable income." Packman, *Tax Shelters: A Non-Dilettante's View*, 53 TAXES 279 (1975).

4. Committee reports make it clear that the changes were motivated by the wide use of tax shelter limited partnerships which led Congress to believe that taxpayers abused some of the partnership provisions. *See* H.R. REP. NO. 658, 94th Cong., 1st Sess. (1975), *reprinted in* U.S. CODE CONG. & AD. NEWS 2897; S. REP. NO. 938, 94th Cong., 2d Sess. (1976) *reprinted in* U.S. CODE CONG. & AD. NEWS 3475.

5. A taxpayer is at-risk with respect to money and the adjusted basis of property he has contributed to the activity. I.R.C. § 465(b) (West 1978). He is also at-risk on money borrowed with respect to an activity if he is personally liable for repayment or if he has pledged property as security for the loan. The pledged property can neither be used in the activity nor financed through a loan secured by other property which the taxpayer has contributed to the activity. § 465, *supra*.

6. I.R.C. § 465(a) (West Supp. 1982).

7. I.R.C. § 465(c)(1)(A) (West Supp. 1982).

8. For an extensive discussion of the effects of the Act upon partnerships, *see* Comment, *New Restrictions on Tax Shelter Limited Partnerships*, 56 NEB. L. REV. 300 (1977). *See also* Weiler, *The 'At Risk' Rules: A New Consideration for Tax Shelter Investments and Partnerships*, 36 N.Y.U. INST. FED. TAX 1351 (1978).

were designed to produce substantial tax benefits through the use of methods to reduce tax liability, such as tax deferral and nonrecourse leveraging. The at-risk provisions substantially limit the use of these methods by individuals and small corporations, thus precluding the pass-through of tax losses to individuals.

Prior to the Act some imprudent investors undoubtedly became involved in partnerships which were economically dubious merely to obtain tax losses.[10] While they correctly eliminate "shady" ventures, the at-risk rules, however, also eliminate some sound business transactions. This article proposes an alternative approach, using tools already available to the Internal Revenue Service. This approach provides the flexibility needed by film investors in order to promote the artistic diversity now lacking in Hollywood.

Part I explores the methods used to finance motion pictures prior to the Act. The at-risk rules are then examined in Part II. The alternate approach proposed is developed in Part III, using case law arising before at-risk times.

PART I: MODES OF TRADITIONAL MOTION PICTURE FINANCING

The primary financing arrangement used by motion picture investors to shelter income before the Act was the "negative pick-up transaction."[11] The investors, through a limited partnership, purchased a finished film from the producer under the negative pick-up.[12] The arrangement normally provided for a down payment with the remaining balance due at a future time, which time depended upon income from the distribution of the motion picture. The investors had no personal

9. The effect of the Act on such partnerships in other activities has also gained extensive treatment in legal periodicals. *See* Dickenson and Sutton, *The Effect of the 1976 Tax Reform Act on the Ownership of Professional Sports Franchises*, 1 COMM/ENT 227 (1977).

10. In fact the Treasury Department did not identify motion pictures as an area of tax shelter abuse in 1973 when it presented its tax shelter proposals to the House Committee on Ways and Means. *See Hearings on General Tax Reform Before the House Committee on Ways and Means*, 93rd Cong., 1st Sess., pt. 18, at 6996-7006 (1973) (Statement of Secretary of the Treasury George P. Schultz). Motion picture tax shelters became an increasingly popular device, however, and the resulting publicity assured that they would be brought to the attention of Congress. *See, e.g.*, *How to Invest in Movies*, BUSINESS WEEK, Aug. 25, 1975, at 73-75, 79-80.

11. *See* Comment, *Motion Picture Tax Shelters: Are the Funds At Risk?*, 28 AM. U.L. REV. 177, 178-180 (1979). *See generally*, Blanc and Williams, *The Impact of the Tax Reform Act of 1976 on Independent Film Production*, 1 REV. TAX. IND. 314 (1977), and Kanter and Eisenberg, *What Alice Sees Through the Looking Glass When Movieland Seeks Creative Financing*, 53 TAXES 94 (1975).

12. *See generally*, Appel, *The Motion Picture Service Company: A Service to the Motion Picture Industry*, 27 U.S. CAL. INST. FED. TAX 559 (1975).

liability for the balance of the fixed purchase price and the only security for payment was income from the film.[13]

Under this type of arrangement, purchasing a film involved a smaller risk of capital than financing the initial production, although the total purchase price could be higher than the production cost. In this way, the investor minimized his potential loss should the film fail to recover its production costs. On the other side, if the film attained box office success, the extra cost of purchasing as opposed to direct financing could be neglible in relation to the potential profits. The purchase of a film using this financing structure provided an investor with the opportunity to gain while it minimized his downside risk of loss.

The investor could also claim the investment tax credit on his basis in the film.[14] From the Internal Revenue Services' perspective, many investors in negative pick-up transactions claimed excessive depreciation deductions by overstating the fair market value of the film[15] and by understating the total estimated income from the film.[16] The Service announced in 1977 that the investors' bases in a partnership engaged in a negative pick-up transaction could not include nonrecourse indebtedness where "the fair market value of the film (does not) at least approximate the amount of the nonrecourse note."[17]

If the purchased film performed poorly at the box office and there was negligible or no net distribution income, the investment was sheltered since the depreciation was deductible and was in excess of the actual cash invested in the film.[18] The investor had an opportunity to

13. *See generally* STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 94th Cong., 1st Sess., *Tax Shelters: Motive Films*, 1-6 (Comm. Print 1975).

14. Walt Disney Prod., Inc. v. U.S. 480 F.2d 66 (9th Cir. 1973), *cert. den.* 415 U.S. 934 (1974) (Motion picture negatives held tangible personal property eligible for the investment tax credit).

15. CCH Internal Revenue Service Tax Shelter Training Manual, § 5.0-5.0125 (Special No. 19) (April 14, 1976).

16. The negative pick-up transaction generated large initial tax losses only where the inconsistent position was taken that the fair market value of the film greatly exceeded the total estimated revenues from the film.

17. Rev. Rul. 77-110, 1977-1 C.B. 58.

18. The accepted method of depreciating films is the "income forecast method." This technique was developed when it was recognized that the usual methods of depreciation (such as straight line or declining balance) creates distortions of income in the case of films. This distortion occurs because 80 to 90 percent of the total revenue from theatrical distribution is normally earned within the first twelve months of distribution. If the straight line method for example, were used over five years, the amount expensed during the first year would be smaller than it should be and in subsequent years the amount expensed would not

recoup all or a part of his actual investment by investing that tax savings attributable to the rapid depreciation.[19] Assuming the film was eventually foreclosed, the investor reported depreciation recapture income in the amount that the unrecovered cost was less than the mortgage balance.[20] The amount initially deductible changed dramatically with the passage of the Act.

PART II: WHAT CONSTITUTES THE AT-RISK AMOUNT

The at-risk provisions now focus on all activities, "Engaged in by the taxpayer in carrying on a trade or business or for the production of income."[21] Under the provision, all taxpayers, with the exception of large corporations,[22] can no longer deduct losses in certain specified activities for a given year in excess of the amount such taxpayers have at-risk in that investment in such year.[23] Therefore, those investing in tax shelters subject to this limitation may no longer take advantage of

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be offset by a proportionate amount of income. The matching principle of accounting would not be met.

The "income-forecast method" of computing depreciation was approved for films by the Internal Revenue Service (hereinafter referred to as "The Service") in Rev. Ruls. 60-358 and 63-273 to prevent these inequities and distortions of income. Under this method, the owner of a film is allowed to depreciate its cost (less a reasonable salvage value) over the period during which the film is expected to produce income, in proportion to the projected realization of receipts for each year of the period. This method provides a better matching of income and expenses and decreases any distortion which would be caused by the other depreciation methods. *See generally* Rev. Rul. 60-358, 1960-2 C.B. 68; Rev. Rul. 64-273, 1964-2 C.B. 62. *See also* Wildman v. Commissioner, 78 T.C. No. 67 (1982).

19. The investor must demonstrate that the purchase price of the film appeared feasible under the circumstances and that proper promotion of the film was reasonably expected based on a distribution agreement with a reputable distributor. If this is shown, he could be entitled to a depreciation deduction computed on the full purchase price at the time, even if the picture did not perform according to his initial projections.

20. An example of this kind of transaction would be as follows: An investor purchases a film for $2,000,000.00, paying 20% down. After he has deducted depreciation of $1,500,000.00 the film is foreclosed, at which time the unpaid balance of the mortgage note is $1,200,000.00. The gain on foreclosure would be $700,000.00, as illustrated below:

CASH	$ 400,000.
PURCHASE MONEY NOTE	$1,600,000.
BASIS	2,000,000.
Less DEPRECIATION TO DATE	1,500,000.
ADJUSTED BASIS	500,000.
UNPAID BALANCE OF NOTE	1,200,000.
GAIN ON FORCLOSURE	700,000.

This payback of the tax savings occurs several years after the initial tax savings, which can be invested during this interim. The time value of money, therefore, works for the investor.

21. § 465(c)(3)(A) *supra* note 2. Real Estate is specifically excluded for the purposes of section 465. *See* I.R.C. § 465(c)(3)(D) (West Supp. 1982).

22. I.R.C. § 465(a)(1) (West Supp. 1982).

23. *Id.*

leveraging, borrowing on a non-recourse basis and then deducting losses from a shelter valued much greater than the actual cash investment.[24]

A taxpayer is considered at-risk in an activity for other property or cash contributed to him to the activity.[25] Amounts borrowed with respect to the activity to the extent that he is personally liable are also included as at-risk.[26] The at-risk amount will not, however, exceed the fair market value of the taxpayer's interest in the secured property.[27] Amounts borrowed at-risk do not include amounts borrowed from any person who has an interest in the activity, other than as a creditor, or amounts borrowed from a related person.[28] Any amounts, even equity capital contributed by the taxpayer, are not treated as at-risk if the amounts are protected against loss through non-recourse financing, guarantees, or other similar arrangements.[29]

The at-risk provisions deprive the negative pick-up of its attractiveness as investors now are strictly limited in their initial deductions. In a negative pick-up the investor is not considered at risk beyond the downpayment.[30]

The most recent addition to the regulations defining the scope of section 465, Temporary Regulations 5-1502-45,[31] illustrates that the at-risk rules preclude reasonable commercial endeavors. Under 5-1502-45, corporations which are subsidiaries to other closely held corporations are limited to a deduction of the lesser of the amount the parent is at risk in the subsidiary or the amount the subsidiary is at risk in the specific activity. These newest regulations operate to deny losses on consolidated returns where no tax sham is evident, even where real economic risk is apparent.[32]

As is often the case, subsidiary corporations are used to enter a new area of business without exposing the parent companies' resources.[33] Such a ploy has been accepted as sound business. As the

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24. *See* Reisman and Taub, *Benefits of Investing in Tax Shelters Remain Despite New Restrictions Clamped on Them*, 5 TAX'N FOR LAW. 196 (1977) (for a more thorough discussion of the Act's impact on tax shelters generally).

25. I.R.C. § 465(b)(1) and (2) (West 1978).

26. *Id.*

27. § 465(b)(2)(B), *supra*.

28. I.R.C. § 465(d)(3)(A) (West 1978).

29. I.R.C. § 465(b)(4) (West 1978).

30. § 465(b)(1), *supra*.

31. Temp. Reg. 5.1502-4.5, T.D. 7685, adopted March 12, 1980.

32. *See generally*, Howard and Rosenberg, *Temp. Regs. Bar Use of Sub to Skirt 'At-Risk' Limits on Consolidated Returns*, J. OF TAX'N, July 1980, at 6.

33. *Id.*

regulations stand, however, the financial statement net worth of the subsidiary is used to calculate the amount at-risk in a subsidiary. This often substantially undervalues the fair market value, thereby foreclosing economically sound ventures.

The purchase of a film was a desirable method of investing provided the individual investor looked first for a sound business deal, and secondly for a tax shelter. The at-risk rules have limited such investments so that the risks normally outweigh the incentives except to the larger movie studios.[34]

PART III: ALTERNATIVES TO AT-RISK

The Congress was divided as to which approach was best to curtail abuses of tax shelters, and chose the at-risk method because of its simplicity.[35] Advancing the argument against the adoption of the at-risk provisions were some who believed that tax shelters provide stimulation to investors, resulting in economic growth and eventual tax revenue increases.[36] On the other end of the spectrum were those in the House who proposed a limitation on artificial losses ("LAL")[37] which would have disallowed offsetting gains in other activities, such as salary with investment loss.[38] The Senate, however, rejected this proposal using the following logic:

> From the economic standpoint, the problem with LAL was that it failed to distinguish between the actual abuses of tax shelters, cases where economically inefficient investments are undertaken purely for tax reasons, and the situations where tax incentives provide important encouragement to economically worthwhile investments. By disallowing deductions in both cases, LAL would have eliminated many productive investments, a serious mistake at a time of high unemployment. This problem would have been especially serious for the real estate and oil and gas industries, since we are falling far short of reaching our . . . goal of energy independence.[39]

The same rationale applies to the film industry as motion pictures em-

34. *See generally* Weisner, *Tax Shelters-A Survey of the Impact of the Tax Reform Act of 1976*, 33 TAX. L. REV. 277 (1978).

35. *See* H.R. REP. NO. 658, *supra* note 4 at 3353-3353.

36. *Id.*

37. Under LAL, Limitation on Artifical Losses, certain deductions such as accelerated depreciation and intangible drilling cost would only be allowed against related income.

38. *See* H.R. REP. No. 658, *supra* note 2959-2963 (for a detailed explanation of this proposal).

39. See S. REP. NO. 938, *supra* note 4.

ploy and involve a significant economic segment of the nation.[40]

A helpful approach to curtail abusive tax shelters is found in *Brountas v. C.I.R.*,[41] where the Tax Court held that a nonrecourse note was a key element of an oil drilling partnership and therefore was at-risk. The court found that the note had economic substance, was indicative of the fair market value of the property for which it was exchanged, and represented a necessary part of the overall business transaction.[42] Because the case presented a factual setting predating the Act and the at-risk provisions, the reasoning of *Brountas* represents an alternative tool available to the Service to control tax shelter abuses.[43]

As in *Brountas*, under drilling ventures an exploratory drilling prospect is presented to the partnership by an operator with a geological assessment. If the spot looks favorable, the drilling partnership purchases the operator's agreement to drill. The operator is paid 40 percent of the price of the leasehold and drilling contract in cash. The remaining balance is secured by a nonrecourse note payable to the operator only through future production.[44] Sometimes several drilling sites are cross-collateralized, allowing the financing of one site to be satisfied from the proceeds of a successful one.

The *Brountas* court held that the nonrecourse notes which the investors gave to the operators had economic significance and were a bona fide and bargained for part of the transactions.[45]

> Where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not adapted solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.[46]

In *Brountas* the court examined the transactions by viewing them as a total package and not by focusing solely on the nonrecourse

40. *See generally*, Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567 (1965) (a theoretical discussion of what constitutes the proper criteria for motivating income tax policy).

41. 73 T.C. 491 (1979).

42. *Id.*

43. The Act was not of "retroactive application." Gibson Products Co. v. U.S., 460 F. Supp. 1109 (N.D. Tex. 1978), *aff'd* 637 F.2d 1041 (5th Cir. 1981).

44. Brountas, *supra* at 567.

45. *Id.* at 540-541.

46. Bountas, *supra* at 539.

notes.[47] The note, though not strictly correllatable to the risks undertaken by the operator, was viewed as, "an economically significant additional piece in the package which compensated the operator" for the obligations he undertook.[48]

As the court did in *Brountas*, the Service should recognize that under these conditions a nonrecourse note is not a tax gimmick, but is an economically sound way in which to structure a business agreement, such as motion picture financing, that is heavily laden with risks.[49]

Conclusion

The total obliteration of all nonrecourse financing through the at-risk rules is too inflexible an approach in industries burdened with risks, such as oil exploration and film production. While the at-risk provisions are convenient to apply, they are not cognizant of the economic realities of the motion picture industry. To obtain the maximum benefit for the economy of each investment, an investment decision should be evaluated by the Service in its entirety.[50]

The *Brountas* rationale provides the Service with the tools necessary to make that evaluation by focusing on the fair market value of the property being exchanged,[51] on the business motivation as opposed to the tax incentives involved,[52] and upon whether the transaction represents "a reasonable range of commercial practice."[53] As long as economic substance and business purpose are found to exist, the at-risk rules should not thwart legitimate business transactions.

When the Act was passed film-makers issued dire predictions that film production would drop as much as fifteen percent. The primary reason production revenues have not dropped in the unforeseen era of the one-hundred million dollar "super-blockbuster," such as Jaws, Star Wars and E.T. The volume of motion pictures now made by the major studios is, however, small compared with the demands for product by theaters.[54] The door to independent production companies can only be

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47. *Id.* at 545.

48. Brountas, *supra* at 544.

49. *See* Shefsky, *Take the Helter Out of Shelter*, 58 TAXES 304 (1980).

50. Brountas, *supra* at 545.

51. *See generally*, Reg. § 1.170A-1(c)(2) (defines fair market value in the context of a charitable contribution in property).

52. *See* Shefsky, *supra* note 51 at 306.

53. Shefsky, *supra* note 51 at 304-304 ("Perhaps the key phrase that best summarizes the court's reasoning in Brountas is 'a reasonable range of commercial practice.' ").

54. *See Soon to be a Major Motion Picture*, FORBES, March 19, 1979 45-49.

opened by a flexible financing structure which minimizes the down-side risks inherent in film production.

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